Committee on the Judiciary
U.S. House of Representatives

Oversight Hearing on Industry Competition and Consolidation:
The Telecom Marketplace Nine Years After the Telecom Act

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Statement of
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Good afternoon, Mr. Chairman and members of the Committee. I am Philip Verveer. I am a partner in Willkie Farr & Gallagher LLP.[1]

I appreciate your invitation to testify on telecommunications industry competition and consolidation. I have spent more than thirty years, almost all of my professional life, considering these matters, as a Justice Department attorney in the AT&T antitrust case, as a bureau chief at the FCC, and as a private attorney.

In the nine years since the passage of the Telecom Act, there has been a telecom boom and bust, significant consolidation among the Baby Bells, disappearance of numerous competitive local exchange carriers and interexchange carriers through liquidation and merger, financial accounting scandals, and now the imminent absorption of AT&T and MCI. And, in the nine years since the passage of the Telecom Act, there has been an enormous expansion of

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[1] My law firm represents companies and associations directly interested in the development and administration of public policies affecting the communications industry. In particular, I want the Committee to be aware of my representation of Sprint Corporation in connection with its proposed merger with Nextel Communications and of Telmex-related interests in connection with their proposed sale of MCI Corporation shares to Verizon Corporation. However, my appearance today is a result of the invitation of the Committee to express my personal views on the state of competition in the telecommunications business. My testimony is not intended to represent any of my firm's clients and it does not necessarily reflect their views.

wireless service, even greater expansion of the Internet, great increases in residential and small business broadband service through cable modem and DSL technologies, lower prices for many telecommunications services, and increasing deployment of digital technology.

So recent history is very mixed. Despite appalling losses of employment and investment with all of their attendant dislocations, there is genuine reason to regard the performance of the telecommunications sector as good and equally genuine reason to protect the process that produced the performance. And that will be challenging because the telecom marketplace nine years after the Telecom Act almost certainly is in the early stage of a fundamental transformation.

The last time this happened was two-to-three decades ago, when the preference for competition over regulated monopoly established itself as the prevailing paradigm in both an intellectual and an operational sense. This preference was reflected in the realm of antitrust law in the divestiture of the Bell System. It was reflected in the realm of regulatory law in policies favoring open entry and disfavoring restrictions on output. The result of this paradigm shift was what its proponents had hoped and predicted. We have had decades of remarkable progressiveness in our communications industries. It is observable in the many products that did not exist in 1975 and in the vastly lower prices for products that did exist. This was not, of course, a matter of single causality. More than anything else, it was a function of technological possibilities being deployed quickly and imaginatively under the pressure of growing competition. One legacy, then, is the great improvements in product variety, quality, and price that we enjoy today. The other is, or at least should be, very strong confidence that policies favoring the dynamic aspects of competition are to be preferred.

In sum, the fundamental transformation of three decades ago turned out to be almost entirely positive. The issue raised by this hearing is whether the current changes will be as well.

The telecom marketplace nine years after the Telecom Act, from the perspective of consumers, offers great promise and some risk. Just as three decades ago, the promise is a function of extraordinarily favorable developments in technology combined with competitive imperatives to reduce the developments to practice and bring them to the marketplace quickly. The risk resides in the equally extraordinary institutional upheaval affecting the production of telecommunications services.

My testimony will address the risk side of the equation. It is important, however, not to lose sight of the enormous benefits that have been produced by the telecommunications sector in the era of divestiture and deregulation and of the high probability that innovation will continue, at an accelerating pace, for the foreseeable future. The policy issues that we confront involve protecting the process that has produced these gains and insuring that they are available across all of our society. In that sense, they are good problems to have.

One way--I think the best way--to consider the risks to our telecommunications future is to consider the state of the institutions on which we depend. What has gotten us to the present desirable state is a workably competitive industry operating in a legal framework that takes seriously the threat of undue market power and seeks to prevent its creation or deter its exercise. The institutional arrangements that embody this experience are today under great pressure.

To begin with the business institutions: the most significant aspects of today's telecommunications marketplace are consolidation and convergence. Both mergers and liquidations have reduced the number of businesses operating across many parts of the telecommunications sector. The most obvious examples involve companies that in traditional terms principally offered local exchange or interexchange services. In parts of telecommunications where this has not yet happened as dramatically--equipment manufacturing and distribution most prominently--it will. All else equal, of course, consolidation threatens to undermine the workably competitive environment that has produced the benefits that our society enjoys today. But the phenomenology of convergence of previously distinct modes of communication means that all else is not equal. Convergence has been anticipated for the better part of forty years. It is occurring dramatically in the case of wireless service displacing wireline service and in the case of local exchange telephone companies and cable television companies competing in what had been the other's core business. [2]

The broader point for public policy is that convergence makes it difficult to assess the competitive effects of consolidation. Both the definition of product market and the identification of suppliers of the product become a great deal more difficult.

One other factor makes competitive assessment more difficult yet. That factor is disruptive technology. Technology, especially digital technology, is drastically affecting the way

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[2] It is instructive that the government's anticipation of this intermodal competition was accompanied by affirmative steps to protect the cable industry and ultimately the public from exercises of market power by the local telephone companies. These affirmative steps took the form of FCC pole attachment regulations and cable-telco crossownership prohibitions that were, in time, incorporated into the Communications Act by Congress. In wireless, they took the form of repeated FCC efforts to force wireline interconnection rates to be reciprocal and reasonable. These measures had costs, as all regulations do, and no doubt produced occasional unintended results, but there is little doubt that today we are better off as a society for the existence of the requirements.

in which telecommunications services are produced just as it is enabling the creation of entirely new services. To take the obvious example, at present it appears that broadband-enabled services will be the preferred objects of consumption in our telecom future. From today's perspective, it also appears that for most consumers and small businesses the broadband transmission will be supplied by one of two providers, either the local telephone company or the local cable company. However, there are two other technological possibilities, wireless and broadband over powerline, that could become important in the supply of broadband transmission services to consumers and small businesses. Overall, it is virtually impossible to predict how quickly and how extensively broadband transmission service will spread across our country, how many providers will be available in any given geographic area, and what the comparative qualities of broadband produced with different technologies will be. There are reasons to be optimistic that broadband will be available in a workably competitive environment and there are reasons to be cautious about our legal and regulatory arrangements in the event that it is not.

Changes of this kind have very large consequences for our assessment of whether businesses enjoying high market shares are in fact as entrenched as the shares might make them appear. By way of example, should we consider the local telephone industry's share of narrowband circuits in the face of possible broadband substitution any differently than we should have considered paging companies' shares in the face of cellular substitution or international telex companies' shares in the face of facsimile substitution? I happen to think that we should, but the possibility of widespread substitution obviously influences any estimate of effective market power.

Given where I believe we find ourselves, in the early stages of a fundamental change in telecommunications industry structure brought about by disruptive technology

resulting in convergence and consolidation, what should we do? The best answer I can provide is, proceed cautiously.

With respect to our legal and regulatory institutions--the Communications Act and the antitrust laws: the recent tendency on the part of the FCC , the Department of Justice, and the courts is to play down the possibility of socially harmful single firm conduct and to play up the possibility that government constraints on single firm conduct will damage consumers and the broader public interest. In some respects, this merely reflects the present state of an endless and ultimately irresolvable debate that is grounded just as firmly in political philosophy as in economics and empirical evidence.[3] Assuming agreed desiderata, is government intervention in the marketplace likely to make matters better or worse? Is it good policy to risk interfering with productive efficiencies for the sake of enabling or protecting additional producers? Is it good policy to risk interfering with productive efficiencies for the sake of distributional considerations? Is it necessary to secure the desired level of investment in new technology to permit investors to appropriate the full value of their investments, or should some of the surplus be spread to consumers and to others in the productive realm?

When we look at the legal and regulatory institutions affecting telecommunications, my thesis is that the present legal tendency in the present industrial context is dangerous. It is dangerous because the industrial setting is changing fundamentally, but the legal arrangements are not reacting to this development in an appropriate way, that is, with caution.

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[3] Arguments over economic regulation are not over whether there should be regulation, but rather over the type of regulation. The dichotomy is between regulation based upon public utility concepts and regulation based upon the law of property, contract, and tort.

From the perspective of regulatory law, what has emerged from both FCC and numerous appellate decisions related to the 1996 Telecommunications Act is a policy that strongly favors incentives to invest and equally strongly avoids intrusions into corporate decisions. In a significant sense, the recent Commission and court decisions can be seen as a reaction against the activist interpretations that constituted the initial FCC effort to implement the 1996 amendments shortly after their passage. The controversy surrounding Unbundled Network Elements constitutes a telling example. Simultaneously, there has been an inability thus far to amend adequately a whole series of important traditional arrangements that have come under pressure as a result of changes in the telecommunications business. These include universal service and intercarrier compensation, major matters that have significant distributional implications. While these issues have only an indirect effect on competition, they contribute to instability in a sector already significantly destabilized by disruptive technology.

From the perspective antitrust law, the observable and incipient changes in the telecommunications industry make Section 7 of the Clayton hard to apply and Section 2 of the Sherman Act more important than ever.

As noted, at the local level the relevant product markets are changing and important competitors are attempting to enter. There is a reasonable basis to debate whether incumbent local exchange companies are more entrenched than ever given the failure of many competitive local exchange carriers and the diminished state of UNE competition, or more vulnerable than ever due to substitution of wireless service and of broadband facilities and internet protocol for narrowband facilities and circuit switching. Whether the substitution will occur on a large scale and over what time frame are uncertainties that inevitably affect the predictive judgments required by Section 7 in ILEC transactions. To say it more simply,

confident predictions are much more difficult when so many of the salient facts are changing. Given the manner in which the Clayton Act distributes burdens of proof--mergers are permissible unless proven harmful--the uncertainties have the effect of permitting mergers. In these circumstances, most telecom mergers would be cleared even if Justice Department policy makers were not philosophically disposed to avoid government intrusion, which they plainly are.

If the vast changes overtaking the telecommunications industry tend to narrow the scope of Section 7, they make Section 2 more important. The monopolization provision is the economy's ultimate protection from the exercise of market power. It seldom is used successfully, but I have always believed that its existence serves to make firms with strong market positions circumspect in the way they use their economic power. This is especially important in telecommunications, where relatively high market shares are commonly found. Given the inherent uncertainties in the telecommunications marketplace, it is particularly important that the residual authority represented by Section 2 remain unimpaired. It is unfortunately the case that it has been impaired recently by Trinko[4] and other decisions in the Goldwasser line of cases.[5]

Trinko seems to me to have materially weakened our ability to rely upon the Sherman Act to correct instances of monopolization as they arise and thus to have weakened its deterrent effect. This is not accidental. The Trinko opinion is remarkably tendentious and unremittingly hostile to the application of the antitrust laws to regulated industries. Three features of the opinion are especially troubling.

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[4] Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004).

[5] Goldwasser v. Ameritech Corp., 222 F.3d 390 (7th Cir. 2000).

The first is extended dicta about the relative capabilities of regulatory agencies and antitrust courts. Trinko gets this exactly backward. The decision greatly overvalues the ability of regulatory agencies to adjudicate competitive disputes and undervalues that of antitrust prosecutors and courts. It does not denigrate the social value of the FCC and of state public service commissions to note that adjudication of competitive disputes is not what they do best. What they do best reflects the essentially legislative nature of regulatory agencies. They are designed and staffed to formulate and articulate policies that apply prospectively. In the process, Commissioners bring to bear their preconceptions about what is best for society and of necessity often compromise among themselves. These tendencies --to draw upon experience and belief rather than solely on a bounded record and to reach pragmatic compromise--are the opposite of adjudication. Although Trinko loads up the scale with the "sometimes considerable disadvantages of antitrust" and the "cost of false positives," the conclusion that competition in telecommunications in its most fundamental aspects will be protected with diminished possibility of Sherman Act prosecutions seems to me utterly wrong.

It also ignores history. As the Competitive Impact Statement in United States v. Western Electric indicated, regulatory failure was one of the bases for the Justice Department's prosecution that led to the Bell System divestiture.[6] The regulatory failure did not reflect a lack of effort on the FCC's part. The FCC had compiled a remarkable record in opening several telecom markets to competition. It also made significant efforts to stop Bell Company violations of its competition-related orders. History makes it clear that the FCC could not do so quickly

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[6] 47 Fed. Reg. 7170 (Feb. 17, 1982).

enough, nor in a way that threatened sanctions for future violations that were sufficiently severe to act as a deterrent.

Trinko's objection that telecom-related antitrust prosecutions bring courts into contact with the "highly technical" does not distinguish them from many other controversies that we ask the courts to consider. The availability of primary jurisdiction referrals offers amelioration of this concern. The related objection that telecom-related judicial decrees could prove difficult to administer is correct, but, again, this does not distinguish them. The goal of a workably competitive telecommunications sector is worth the price of imperfect remedies, even recognizing the risk that they could inadvertently deter some socially beneficial conduct.

The second and more significant concern stemming from the Trinko decision is the way in which it approaches Section 2. Similar to others in the Goldwasser line of cases, it invites an examination of component parts rather than of the whole. This approach looks at a course of conduct one element at a time and dismisses each as lawful or as individually immunized and then concludes, based on these intermediate steps, that there is no violation.[7] Prior to Trinko, the Supreme Court had found this methodology to be impermissible.[8] In other words, monopolization is an independent violation of the antitrust laws. A finding of liability does not depend on finding that a component activity in a course of conduct separately and

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[7] Covad Communications Co. v. Bell Atlantic Corp., 398 F.3d 666 (D.C. Cir. 2005), decided on the basis of the Trinko precedent, provides an example of the diminution of Section 2 through the device of segmenting an alleged illegal course of conduct.

[8] "Plaintiffs should be given the full benefit of their proof without tightly compartmentalizing the various factual components and wiping the slate clean after scrutiny of each." Continental Ore Co. v. Union Carbide & Carbon Corp., 370 U.S. 690, 699 (1962). This citation often invokes rejoinders that Continental Ore is not authoritative on this point. I note that the Antitrust Division relied upon Continental Ore for precisely this point in its Section 2 prosecution of Microsoft.

individually violates the antitrust laws. If it is to be effective, Section 2 must require that courts look at the alleged conduct whole. It should not matter if each of the individual components is lawful, benign, or immune when viewed in isolation if the end result, taken as a whole, adds up to an anticompetitive effort to maintain a monopoly.

Looking at a course of conduct one element at a time highlights a third, particularly troubling feature of the Trinko opinion. As with other cases in the Goldwasser line, it tends to conjure idealized or imaginary commercial environments largely free of positive law, or at least regulatory law, strictures. It seeks to measure a firm's conduct not against the law as it exists, but against some conception of the law as it once was or should be. Section 2 should not be predicated on this type of fictive environment, reduced to a game of counterfactuals. It was designed to, and to be effective in protecting competition in telecommunications it must, take the world as it finds it, including the world of positive law-required or -influenced activity. In other words, whether a course of conduct constitutes monopolization or attempted monopolization should be determined against the commercial realities as they actually exist. Those realities are influenced in many ways by positive, statutory law. The proposition that positive law and the legal obligations it creates should be ignored in determining if monopolization has occurred is exceedingly strange, but if and as it is adopted and extended it will deprive our telecommunications industries, and other regulated industries as well, of protection against monopolization.

To conclude, the availability of the antitrust laws, and especially of the Sherman Act, to protect the competitive process in telecommunications is as important today as it ever has been. Recent judicial decisions have tended to diminish our ability to rely upon the Sherman

Act. This is an issue that should be a priority in connection with any legislation or oversight involving the communications industries.